CWB | CANADIAN WESTERN BANK GROUP

November 15, 2016

<via email LegislativeReview-ExamenLegislatif@canada.ca>

Financial Institutions Division
Financial Sector Policy Branch
Department of Finance Canada
James Michael Flaherty Building
90 Elgin Street
Ottawa, ON K1A 0G5

Canadian Western Bank (CWB) is pleased to provide its perspective on the Consultation Document for the Review of the Federal Financial Sector Framework (Consultation Document) issued by the Department of Finance Canada (the Government) on August 26, 2016. Changes in the financial sector, both in the regulatory requirements as well as consumer expectations, support a comprehensive review of the federal financial sector framework at this time.

CWB is the seventh largest publicly traded bank based on market capitalization. CWB offers, directly and indirectly through its subsidiaries, full service banking, leasing, trust and wealth management services. With over $25 billion in assets, CWB is one of only a few mid-sized banks in Canada and the only Canadian bank primarily focused on supporting Canadian mid-market businesses. It also has 74% of its loans in British Columbia and Alberta. CWB is a unique financial institution in Canada in that its primary focus is on mid-market commercial lending, rather than personal and residential mortgage lending.

The Consultation Paper sets out three core policy objectives that guide financial sector policy: stability, efficiency and utility. CWB strongly supports these objectives. These objectives also have a direct impact on a fourth objective, the need to foster and support a competitive environment for all federal financial institutions. Notwithstanding the Government's stated intent to foster and support competition in the federally regulated financial sector, the Consultation Paper notes that the six largest banks in Canada now have 93% of assets in the banking sub-sector and that the assets of the three largest banks as a percentage of total bank assets have increased from 54% in 2002 to 65% in 2015. The paper also notes that small and mid-sized financial institutions have argued that they face challenges in competing and growing due to proportionately higher regulatory burden and prudential requirements relative to large banks.

Although the Office of the Superintendent of Financial Institutions (OSFI) has undertaken initiatives to manage the compliance burden when it perceives little risk in doing so, the most important determinant of entry into the

sector, as well as the business mix a bank will pursue over time, is largely determined by regulatory capital which is set at the international level by the Basel Committee on Banking Supervision (Basel Committee) and applied by OSFI through its capital guidelines to all Canadian banks. As prudential regulator, OSFI is focused on only one of the Government's priorities, stability. Capital requirements, both in quantity and quality, have been steadily increasing since the global financial crisis and are proposed to be augmented again with the result that Canadian banks will be expected to hold even more capital against their current loan mix.

CWB believes that the Bank Act and the Office of the Superintendent of Financial Institutions Act do not adequately address the required balance between the three stated policy objectives as well as the added objective of creating a competitive environment in the Canadian banking sector. Although all federally regulated banks have been subject to increasingly higher capital requirements, in our view the Canadian non-domestic systemically important banks (D-SIBs) utilizing the standardized method of calculating regulatory capital have been disproportionately impacted and are over regulated based on the overall systemic risk that these institutions pose to the Canadian financial system. We therefore believe that the scope of the Government's review should be expanded to include the impact of regulatory capital and, in particular, whether current and proposed capital requirements are supportive or detrimental to the Government's stated policy objectives.

The Basel Committee

Since the Basel Committee itself has no legislative power, each member country has the option to implement the Basel standards. Although the implementation of such standards requires legislative approval in some jurisdictions, in Canada, the requirements are implemented solely by OSFI through its capital guidelines, with no formal legislative approval.

The history of the Basel Committee and original Capital Accord can be traced to needs for regulation of internationally active banks that arose in the 1970s and 1980s.[1] In 2010, the third iteration of Basel (known as Basel III) was announced in the form of higher global minimum capital standards for commercial banks, as well as changes to the overall design of the capital and liquidity requirements.[2] As stated by the Basel Committee, "These enhancements were part of a broader effort to strengthen the regulation and supervision of internationally active banks, in the light of weaknesses revealed by the financial market crisis."

[1] The predecessor to the Basel Committee was established in 1974 after many international banks incurred large foreign currency losses. The committee focused on gaps in international supervisory coverage which resulted in foreign banking establishments escaping supervision and on ensuring supervision was adequate and consistent across member jurisdictions. In the early 1980s, the onset of the Latin American debt crisis resulted in recognition of the need for a multinational accord to strengthen the stability of the international banking system and to remove competitive inequality arising from differences in national capital requirements. The committee released the Basel Capital Accord (1988 Accord) (known as Basel I) in July 1988 which called for a minimum capital ratio of capital to risk weighted assets. Basel II, released in 2004, contained changes to the capital requirements which were aimed at rewarding and encouraging continued improvements in risk measurement and control.

[2] These rules introduced additional layers of capital including a capital conservation buffer, a countercyclical capital buffer, and a supplementary capital for systemically important banks as well as a leverage ratio and a minimum liquidity ratio.

Notwithstanding the Basel Committee's focus on internationally active banks, the capital requirements are imposed on all banks in Canada.

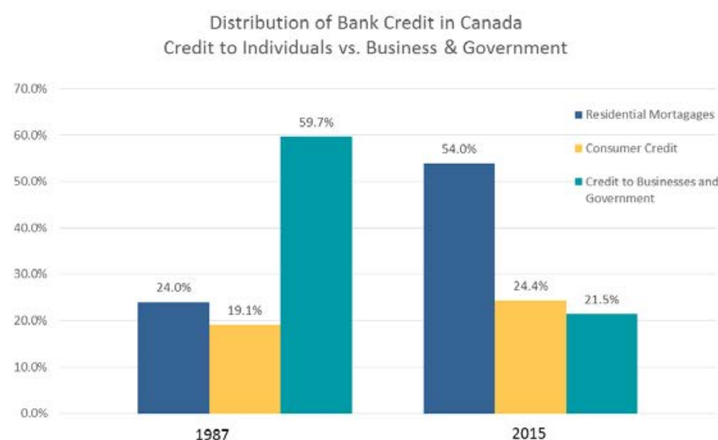
The Impact of Capital Requirements

A prime example of the disconnect between public policy objectives and the regulation of bank capital through the application of the Basel Accord, can be illustrated in the capital requirements for new banks. In an attempt to encourage new entrants into the banking sector, the Government amended the Bank Act in 2001 to reduce the minimum amount of capital required to establish a bank from $10 million to $5 million. This provision in the Bank Act however has had a limited impact due to OSFI's application of the Basel capital framework to all banks. OSFI's *Guide for Incorporating Banks and Federally Regulated Trust and Loan Companies* states that despite the statutory minimum of $5 million, the initial capital of a new bank must both meet the requirements of OSFI's current Capital Adequacy Requirements (CAR) Guideline and be sufficient, at all times, for the institution to remain above its target risk-based capital ratios and leverage ratios for the longer of the first three years of operations, or until it is profitable under a base case scenario. The Guide also requires that these capital projections be fully stress-tested against adverse scenarios.

Furthermore, the fact that the Basel capital framework sets out capital requirements by loan type encourages lending across the industry to fit within a specific mix of retail (with lower capital requirements) and commercial business (with higher capital requirements) that all large banks have converged towards.[3] Smaller institutions that may wish to focus on providing credit to a particular business niche, or that are still growing their balance sheets, will not always be able to align with the optimal Basel portfolio mix and face a distinct capital disadvantage. In fact, we are not aware of any new Canadian bank with a commercial lending focus that has been approved by OSFI since the introduction of Basel II.

The allocation of capital by loan type under Basel has had a significant impact on the loan mix of the large Canadian banks as shown on the chart below which compares the distribution of credit to individuals compared to business and government in 1987 (prior to Basel I) and in 2015 (under Basel III).

[3] Higher capital requirements for specific types of loans – such as to commercial clients – constrain the amount of business that a bank can generate from a given amount of capital. Banks with more commercial business in their portfolio will not be able to support a return on capital as high as another bank with a retail focused portfolio that requires lower capital.



The above chart illustrates how the Basel accords have channelled credit to different sectors of the Canadian economy without formal legislative approval and independent of public policy. Furthermore, the higher capital requirements for commercial lending acts to restrict the access to credit of Canadian small businesses in favor of lowering the cost of retail lending to highly leveraged Canadian households.

To reward and encourage improvements in risk management, Basel II introduced the Advanced Internal Rate Based (AIRB) method of determining capital as an alternative to utilizing the standardized rates set forth in Basel. With robust risk management processes and supervisory approval, AIRB permits a bank to utilize internal model based risk weightings to calculate regulatory capital. The size of the loan portfolio is a material factor in whether a bank can develop the models required under AIRB. Only the Canadian D-SIBs are presently approved to utilize AIRB.

The impact of the Basel III capital requirements, together with the fact that only the six largest Canadian banks have transitioned to the AIRB method of calculating risk weighted assets, has resulted in the remaining Canadian banks having to hold significantly more capital under the standardized approach for the same type of loan and same credit risk. The chart below illustrates the average risk-weighting held by each of the AIRB banks compared to the average risk weighting of non AIRB bank such as CWB and Laurentian Bank (note that higher risk weights require more capital). These higher capital requirements are imposed even though the non AIRB bank may have a superior loan loss record. There is also no direct correlation between the higher capital requirement under the standardized approach and the risk the smaller bank represents to the financial system.

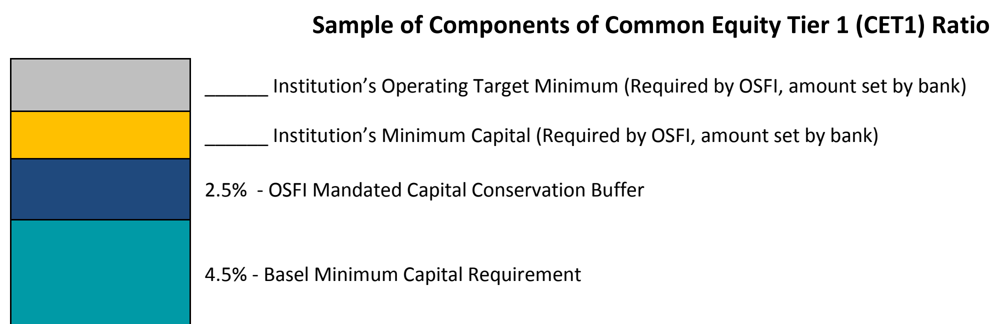
	Standardized		Advanced Internal Rating Based (AIRB)						Average
	CWB	LB	BMO	BNS	CM	NA	RY	TD	(AIRB banks)
Risk weightings by category[1]									
Residential mortgages	36%	17%	8%	12%	6%	11%	6%	9%	9%
Other retail loans[2]	76%	65%	25%	42%	31%	38%	23%	46%	34%
Business loans[3]	100%	100%	41%	61%	39%	49%	54%	44%	48%

[1] "Risk weightings by category" based on Oct 31, 2015 company reports of Canada's eight publicly traded Schedule 1 banks.
[2] Other retail includes personal loans, credit cards and small business loans treated as retail.
[3] Business includes corporate, commercial, medium-sized enterprises and non-bank financial institutions.

Non AIRB banks that specialize in servicing the financial needs of small to medium sized businesses are at a competitive disadvantage in terms of the higher capital that they have to hold relative to the large dominant Canadian Banks. This is because commercial loans represent a higher percentage of their overall portfolio as well as the fact non-AIRB banks currently utilize the standardized method of calculating risk weighted assets and therefore carry more capital compared to AIRB banks for the same credit risk. This limits the ability of smaller banks to focus on the business segment. Notwithstanding the significant impact of capital requirements on competition, products offered and the potential systemic risk associated with federal banks all incentivized to offer the same types of credit, there is no mention in the Consultation Paper of the need to examine the effects of capital requirements on the policy objectives of the Government.

Although the Basel requirements continue to focus on internationally active banks, the requirements, including multiple buffers over the stated minimums, are applied to every bank in Canada. The result is set out below:

Sample of Components of Common Equity Tier 1 (CET1) Ratio



Banks designated as D-SIBs, which are currently Canada's six largest banks, carry an additional 1% capital surcharge based on their risk weighted assets. However, because they utilize AIRB, the D-SIBs carry materially less capital in every category of loan than the non-D-SIBs, even though the non-D-SIBs, by definition, do not pose the same systemic risk to the financial system.

The capital requirements are expected to become even more onerous over the next few years, particularly with respect to certain types of commercial lending. The Basel Committee has released proposed capital amendments which are expected to be final in early 2017. If implemented as drafted, these requirements will significantly increase the capital requirements under the Standardized method for certain types of commercial lending. We believe these proposals will further drive the continued focus of banks on the retail lending segment.

In our opinion, when the new capital requirements are implemented, it will be even more challenging for any bank utilizing the standardized method to primarily offer commercial lending in a manner that supports an acceptable return on capital for its shareholders. Therefore in order to remain competitive against the AIRB banks, CWB has commenced a multi-year project to enhance our risk management framework and processes and pursue AIRB approval.

Conclusion

The safety and soundness of the Canadian banking sector is of great importance to Canadians, the Government, and all participants in the banking sector. The strength of the Canadian banking system was demonstrated during the 2008-9 global financial crisis during which period no Canadian bank failed even though the banks were operating under the lower capital requirements of Basel II. We believe that the continuing increase in capital levels to all Canadian banks is having an adverse impact on other Government policy objectives such as increased competition in the financial sector. We therefore encourage the Government to expand the scope of its review to include the impact of the relative levels of regulatory capital between D-SIBs and non-D-SIBS and, in particular, whether current and proposed capital requirements are supportive or detrimental to the Government's stated policy objectives.

Thank you for the opportunity to participate in the consultation process.

Sincerely,

CANADIAN WESTERN BANK

Chris Fowler
President and Chief Executive Officer